

**ILLINOIS COMMERCE COMMISSION**

**DOCKET NO. \_\_\_\_\_**

**DIRECT TESTIMONY**

**OF**

**STEVEN M. FETTER**

**Submitted On Behalf**

**Of**

**CENTRAL ILLINOIS LIGHT COMPANY  
CENTRAL ILLINOIS PUBLIC SERVICE COMPANY  
ILLINOIS POWER COMPANY**

**February 28, 2005**

1 I. **Background and Qualifications**

2 Q. **Please state your name.**

3 A. My name is Steven M. Fetter.

4 Q. **Please state your current occupation.**

5 A. I am President of Regulation UnFettered, an energy advisory firm I started in  
6 April 2002.

7 Q. **Please briefly describe your role as President of Regulation UnFettered.**

8 A. As President of Regulation UnFettered, I use my financial, regulatory, legislative  
9 and legal expertise to aid the deliberations of regulators, legislative bodies, and  
10 the courts, and to assist them in evaluating regulatory issues. My clients include  
11 electric and gas utilities, state public utility commissions, state consumer  
12 advocates, a non-utility energy supplier, international financial services and  
13 consulting firms, and investors.

14 Q. **Please briefly describe your educational background and your relevant work  
15 history prior to starting Regulation UnFettered.**

16 A. In 1974 I graduated with high honors from the University of Michigan with an  
17 A.B. in Communications, and in 1979 I graduated from the University of  
18 Michigan Law School with a J.D.

19 Prior to starting Regulation UnFettered, I was employed by Fitch, Inc. ("Fitch"), a  
20 credit rating agency based in New York and London. Fitch is the third largest full  
21 service credit rating agency in the United States and the largest European rating  
22 agency. It is also one of four Nationally Recognized Statistical Rating  
23 Organizations recognized by the U.S. Securities and Exchange Commission, and

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is also recognized by the U.S. Department of Labor, state bank and thrift regulators, and the National Association of Insurance Commissioners. Fitch performs credit ratings of corporate obligations, asset-backed transactions, and government and municipal debt. I started with Fitch in October of 1993 as the Senior Vice President and Director of Regulatory and Government Affairs. I subsequently served as a Group Head and Managing Director of the Global Power Group within Fitch. In that role, I served as group manager of the combined 18-person New York and Chicago Utility Team and was also responsible for interpreting the impact of regulatory and legislative developments on utility credit ratings. A month after I left Fitch to start Regulation UnFettered, Fitch retained me as a consultant.

Prior to joining Fitch, I was employed by the Michigan Public Service Commission ("MPSC"). In October of 1987 I was appointed as a Commissioner to the three-member MPSC by Democratic Governor James Blanchard. In January of 1991, I was promoted to Chairman by incoming Republican Governor John Engler, who reappointed me in July of 1993. During my tenure as Chairman, the MPSC eliminated the agency's case backlog for the first time in 23 years.

Prior to my service on the MPSC, I was employed by the U.S. Department of Labor in Washington, D.C. from August 1985 until October 1987. While employed by the U.S. Department of Labor, I served as an executive assistant to the Deputy Under Secretary of Labor and later was Acting Associate Deputy Under Secretary of Labor. During the period from January 1983 until August

1985, I was legal counsel within the Michigan Senate and later was appointed Senate Majority General Counsel. From March 1982 through January 1983, I served as assistant legal counsel to Michigan Governor William Milliken. Prior to March 1982, I was employed as an appellate litigation attorney for the National Labor Relations Board in Washington, D.C.

Please refer to my curriculum vitae, attached hereto as Resp. Exhibit 8.1, for a list of additional qualifications and relevant experience.

**Q. Have you previously sponsored testimony before regulatory or legislative bodies?**

A. Yes. Since 1990, I have testified on numerous occasions before the U.S. Senate, the U.S. House of Representatives, and various federal and state legislative, regulatory, and judicial bodies on the subjects of credit risk within the utility sector, electric utility restructuring, utility securitization bonds, and nuclear energy.

## **II. Purpose of Testimony and Summary of Conclusions**

**Q. What is the purpose of your testimony?**

A. The purpose of my testimony is to discuss key concepts espoused by Central Illinois Light Company d/b/a AmerenCILCO, Central Illinois Public Service Company d/b/a AmerenCIPS and Illinois Power Company d/b/a AmerenIP (the "Ameren Companies" or "Companies") in their testimony that I believe the Illinois Commerce Commission ("ICC" or "Commission") should take into account as it structures the framework for the state's power supply bidding system. I focus on the importance of allowing electric distribution utilities to set

70 reasonable credit quality requirements for potential suppliers so as to limit the  
71 likelihood of a later supply default and shortfall, which could trigger the need for  
72 the purchasing utilities to take immediate remedial action amidst an atmosphere  
73 of uncertainty.

74 I proceed to explain how the major credit rating agencies closely  
75 scrutinize the likelihood that distribution utilities will recover the costs flowing  
76 from their power supply contracts that result from the auction process approved  
77 by the ICC. To the extent that any uncertainty exists as to recovery of such costs,  
78 the rating agencies factor this risk into the purchasing utilities' credit profiles by  
79 imputing higher debt and interest levels. These modifications to a utility's capital  
80 structure and key financial measures could have a negative effect on the credit  
81 rating assigned to that company.

82 Finally, I discuss the importance of the ICC providing an approved  
83 protocol for distribution utilities to follow in case of supplier default and the need  
84 to contract for replacement power. I conclude that the interests of all stakeholders  
85 within the auction process are best served by having the ICC define in advance  
86 the steps that a distribution utility should follow in that instance. By doing so, the  
87 Commission will facilitate expeditious action by the utilities to maintain reliable  
88 supply to the consumer, while shielding their investors from uncertainty and risk  
89 that is caused by events outside the distribution utility's control.

90 **Q. Do you offer opinions based upon your background and expertise?**

91 A. Yes. The opinions I express in my testimony are based upon my experience as  
92 head of the utility ratings practice at a major credit rating agency and chairman of

193 a state public utility commission. Any recommendations I provide are consistent  
194 with the beliefs I held and the actions I took while serving in those positions.

195 **III. Discussion**

196 **A) The Supplier Credit Quality Requirements that the Ameren Companies**  
197 **Have Included in their Power Supply Contracts Are Consistent with Electric**  
198 **Industry Practice and Are Appropriate.**

199 **Q. Have you reviewed the credit quality requirements that the Ameren**  
200 **Companies have included in the power supply contracts they intend to use in**  
201 **connection with the competitive procurement auction ("CPA")?**

202 **A.** Yes, I have.

203 **Q. Could you summarize those requirements?**

204 **A.** Yes. I have attached the relevant section of the proposed power supply contract  
205 to my testimony (Article 6) as Resp. Exhibit 8.2. I will provide a concise  
206 summary of the credit quality requirements included within the contract in my  
207 own words here:

208 Qualification to be a supplier can be based upon creditworthiness or  
209 through provision of a security deposit with the Companies. For a supplier to be  
210 granted an unsecured line of credit, it must be rated by at least two of the three  
211 major rating agencies – Standard & Poor's (S&P), Moody's and Fitch – with a  
212 minimum senior unsecured debt rating (or, if unavailable, a corporate issuer rating  
213 discounted by one notch) of at least "BBB-" from S&P or Fitch, or "Baa3" from  
214 Moody's. Using the supplier's credit rating levels, the Companies will calculate  
215 the maximum level of a supplier's credit limit to cover that supplier's mark-to-

116 market credit exposure (the difference between its obligations under its supply  
117 contract and forward market conditions). Depending upon the supplier's credit  
118 rating level, its maximum credit limit can vary from \$0, if below investment-  
119 grade, to \$20,000,000, if "BBB-/Baa3", to up to \$80,000,000, if its ratings are at  
120 or above "A-/A3". If the supplier has a guarantor, the guarantor would be subject  
121 to the same standards described above. As an alternative to satisfying any of  
122 these requirements, a supplier (or its guarantor) may post cash or a letter of credit  
123 for the entire amount of its credit exposure.

124 For suppliers or guarantors not incorporated under U.S. law, those entities  
125 (as an alternative to cash or a letter of credit) will be required to provide such  
126 evidence of creditworthiness as to provide the Companies with comparable  
127 assurances of creditworthiness consistent with the standards described above.

128 If at any time credit exposure exceeds a supplier's credit limit and posted  
129 security, the Companies may request a margin call under which the supplier will  
130 be required to provide additional margin in the form of cash or letter of credit.

131 In case of a credit rating downgrade of the Companies to below  
132 investment-grade level, suppliers may seek the return of cash held as security and  
133 require accelerated payments under the applicable contracts. Suppliers shall  
134 promptly notify the Companies of any credit rating changes (or credit watches  
135 with negative implications) and also any materially adverse change in their or  
136 their guarantors' financial condition. In cases of credit rating downgrades,  
137 suppliers may be obligated to provide additional security to the Companies.

138               Finally, the Companies may establish less restrictive creditworthiness  
139 standards than those specifically cited within the proposed contract provided they  
140 do so in a non-discriminatory manner.

141               These items and others are described in much greater detail within the  
142 proposed contracts, which are sponsored by Mr. James Blessing.

143   **Q.    What is the purpose of these credit requirements?**

144   A.    The ICC will be approving a complex process through which electric distribution  
145 utilities will be able to procure needed power supply to provide reliable service to  
146 their core customers. If any entity within the procurement process or, thereafter,  
147 during the supply process is unable to meet its obligations, the best intentions of  
148 the Commission to provide reliable power supply at reasonable rates tied to  
149 market levels will be placed into significant jeopardy. I firmly believe that the  
150 best way to avoid such turmoil and uncertainty is to have appropriate standards  
151 for pre-qualifying suppliers, and also, as is proposed, holding the Companies to  
152 financial quality requirements as well. Through this approach, all participants  
153 will have a significant amount of protection ensuring fair treatment, most  
154 especially the consumer, whose interest in receiving reliable power at a fair price  
155 can best be met if the power procurement process operates smoothly and  
156 efficiently from start to finish. In addition, all of the other parties with a stake in  
157 the functioning of the process and its end result benefit if no undue impediments  
158 arise – these include the distribution utilities, their suppliers, and the equity and  
159 debt investors which support entities on both sides of these contractual  
160 commitments. No one is served if the process does not operate consistent with



161 the framework ultimately approved by the Commission. My view is that the  
162 creditworthiness requirements that I summarized will help to meet the overall  
163 public interest goals of the ICC framework.

164 **Q. Do you believe that the credit quality standards that have been proposed are**  
165 **reasonable?**

166 A. Yes, I do. These credit quality standards will meet the purposes and objectives I  
167 described above. In addition, New Jersey is viewed by many as the leading state  
168 in the regulatory community for having moved forward in implementing a power  
169 supply auction similar to the one that Illinois is putting in place. The credit  
170 requirements set out by the New Jersey Board of Public Utilities in its approved  
171 power supply contract had the same goals that are being sought here and are  
172 consistent with the credit requirements the Companies have included in the  
173 proposed power supply contracts.

174 **Q. Would you discuss the concept of Independent Credit Requirements and how**  
175 **they fit into the credit quality framework proposed by the Companies?**

176 A. Independent Credit Requirements, or ICRs, can be structured in different ways.  
177 At times, they can be utilized as an amount to protect a distribution utility in the  
178 event that energy and capacity prices move between the time of a default by a  
179 supplier up until the date that damages owed to the purchasing utility are  
180 calculated. Alternatively, they can be used as additional security upfront at the  
181 time that a contract between the purchasing utility and the power supplier is  
182 signed.

183 **Q. How do the Companies use ICRs here?**

184 A. It is my understanding from Ameren management that the Companies have  
185 attempted to treat potential power suppliers within the auction process consistent  
186 with the manner that the Companies and other Ameren affiliates carry on their  
187 usual contracting activities. For the most part, Ameren affiliates do not require  
188 ICRs in their contracts, either as a supplier or as a purchaser. Thus, the  
189 Companies are not including ICRs within the credit quality requirements here.

190 **Q. Does the absence of an ICR provision cause any concern to you?**

191 A. No, it does not. The absence of ICR provisions are consistent with standard  
192 electric industry practice, as shown by their absence in the Edison Electric  
193 Institute "Master Power Purchase & Agreement", upon which many in the electric  
194 industry rely in fashioning their own company agreements with suppliers.

195 **B) Credit Rating Agencies Place Great Weight on the Likelihood of Power  
196 Supply Cost Recovery in the Setting of Bond Ratings.**

197 **Q. Have the major credit rating agencies addressed the subject of purchased  
198 power contracts and their potential effect on credit ratings?**

199 A. Yes they have. S&P and Fitch have publicly addressed this issue, with S&P  
200 providing the most explicit guidance. I have appended S&P's research report  
201 entitled "'Buy Versus Build': Debt Aspects of Purchased-Power Agreements"<sup>1</sup> to  
202 my testimony as Resp. Exhibit 8.3. The report directly ties the risk of non-  
203 recovery of purchased power contract costs to the determination of credit ratings.

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<sup>1</sup> S&P's research report was issued May 3, 2003.

204 Q. And Fitch's view?

205 A. I have attached, as Resp. Exhibit 8.4, a presentation Fitch made in April 2004  
206 entitled "Fitch Global Power Methodology and Criteria – Debt-Like Obligations  
207 and Contracts Other Than Funded Debt." It addresses these same issues.

208 Q. Based upon your experience as group head of the utility ratings practice at  
209 Fitch, can you discuss how the two agencies view purchased power contracts  
210 and the potential recovery of such costs as they relate to utility credit  
211 ratings?

212 A. Yes, I can. Basically, the concept is that purchased power agreements ("PPAs")  
213 create long-term obligations on the part of utilities that have to be met on a timely  
214 basis, just as debt instruments such as long-term bonds are required to have their  
215 principal and interest paid on a timely basis. For this reason, the rating agencies  
216 frequently impute a higher debt level and increased interest charges and modify  
217 the affected utility's capital structure accordingly. The imputed or modified  
218 capital structure and key financial measures are then utilized within the agencies'  
219 analysis and determination of credit ratings. The S&P report explains that the  
220 agency:

221 evaluates the benefits and risks of purchased power by adjusting a  
222 purchasing utility's reported financial statements to allow for more  
223 meaningful comparisons with utilities that build generation. Utilities that  
224 build typically finance construction with a mix of debt and equity. A  
225 utility that leases a power plant has entered into a debt transaction for that  
226 facility; a capital lease appears on the utility's balance sheet as debt. A  
227 PPA is a similar fixed commitment. When a utility enters into a long-term  
228 PPA with a fixed-cost component, it takes on financial risk...As a generic  
229 guideline for utilities with PPAs included as an operating expense in base  
230 tariffs, [S&P] believes that a 50% risk factor is appropriate for long-term  
231 commitments (e.g. tenors greater than three years). This risk factor  
232 assumes adequate regulatory treatment, including recognition of the PPAs

233 in tariffs; otherwise a higher risk factor could be adopted to indicate  
234 greater risk of recovery.

235 Thus, S&P factors the existence of PPAs into credit ratings because the recovery  
236 of purchased power costs is essential to the ability of bondholders to receive the  
237 principal and interest that is due them on a timely basis.

238 **Q. Does Fitch hold a similar view?**

239 A. Yes, it does. An important concept that Fitch focuses on is: "Does an issuer have  
240 a high likelihood of recovering costs under the contract from ultimate consumers  
241 (or another counterparty)?" Resp. Exhibit 8.4, slide 2. Factors that enter into the  
242 Fitch analysis include "level of regulatory support and recovery mechanisms; lag  
243 in regulatory recovery; probability of disallowance." Resp. Exhibit 8.4, slide 4.  
244 To the extent that risk is introduced into any of these variables and ultimately into  
245 cost recovery, Fitch would capitalize a portion of the contract obligation to impute  
246 debt and interest changes and it would serve as a negative factor in the overall  
247 credit rating analysis of the affected utility.

248 **Q. Would you find it to be anomalous for a bidding procurement system to be**  
249 **structured where the end result of an open and fair process could be denied**  
250 **recovery?**

251 A. Yes I would, though after having endured the California debacle as a credit rating  
252 analyst on the firing line, I have learned to take nothing for granted in the  
253 evolving restructuring of the electric utility sector. I think it is important that a  
254 rational process be defined from start – initial request for proposal – to finish –  
255 recovery of expenditures resulting from a commission-approved bidding process.  
256 Even with all of those parameters defined, credit rating agencies would still see a

257 certain degree of risk with regard to potential supplier default and the need for the  
258 distribution utility to take immediate steps to procure replacement power on a  
259 real-time basis – actions which might be subject to a later after-the-fact prudence  
260 review by the Commission as it considers cost recovery.

261 **C) In the Event of Power Supply Contract Default, Replacement Power**  
262 **Purchases Made By Ameren Pursuant to a Process Approved by the Illinois**  
263 **Commerce Commission Should Be Entitled to Full Recovery.**

264 **Q. You earlier discussed the appropriate use by the Companies of credit**  
265 **requirements in supplier contracts to attempt to avoid a supplier default on**  
266 **its obligations. If, after all that, a default were to occur, do you believe that,**  
267 **if the Companies follow a Commission-approved process for dealing with**  
268 **such shortfalls through replacement power purchases, those expenditures**  
269 **should be entitled to full recovery?**

270 **A.** Yes I do. When any kind of contractual default occurs, conditions are inevitably  
271 inferior to what they would have been under the normal execution of the contract.  
272 I encourage the Commission to formulate a protocol that it is comfortable with as  
273 to the actions that the Ameren Companies and other distribution utilities should  
274 take when such an emergency occurs. By doing so in advance, the Commission  
275 will be taking an affirmative step to prevent future difficult circumstances from  
276 getting worse due to delay or uncertainty, and will be providing upfront guidance  
277 as to what it expects of a utility facing such a problem, thus allowing the affected  
278 utility to act expeditiously to remedy the negative situation. When a contractual  
279 default is pending is not the time for the utility or the Commission to be making

280 prudence judgments in the back of their mind or on the back of an envelope prior  
281 to taking the steps needed to fix the situation and limit the damaging effects on  
282 consumers. Indeed, S&P, in the report I cited earlier, alluded to this very situation  
283 as one of its risk factors: "To the extent that energy is not delivered, the utility  
284 will be exposed to replacing this power, potentially at market rates that could be  
285 higher than contracted rates and potentially not recoverable in tariffs." As a  
286 former utility regulator and bond rater, I strongly recommend that this be a risk  
287 that is dealt with by the Commission at the outset, not by the utility at a time when  
288 decisive action is critical.

289 **Q. Does this conclude your testimony?**

290 **A.** Yes it does.